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EFFECTIVE AND LAWFUL AVOIDANCE OF TAXES.

IT IS the purpose of this article to point out fundamental differences between methods of avoiding or reducing taxes which may safely be regarded as effective and lawful as distinguished from forbidden evasion.

The distinction is of the utmost importance to the taxpayer, since the courts will set aside a transaction so far as taxes are concerned when evasion has been practised, and Federal and State statutes add additional penalties of fines and imprisonment in many cases of "fraud upon the revenue." Tax avoidance on the other hand is an effective and legally innocent method of saving, and in the sense that a penny saved is a penny earned, tax avoidance means a net profit.

In the public mind, methods of tax reduction, saving or avoidance are often said to be confused with tax "evasion" or tax "dodging" and to all methods of tax saving is often imputed a moral guilt, if not a legal risk and liability. One of the speakers at a recent conference of tax experts speaks of shifting taxes as "tax dodging", without mention of distinction of legitimate and illegitimate methods and says: "It seems to be a popular notion amongst most people that any burden of taxation they can get away from is perfectly legitimate and proper."¹ If the means adopted do not constitute "bad faith" or "fraud", then this popular idea is correct, according to my understanding, and furthermore it seems to me to be unfortunate that this distinction should not always be kept in mind. Many rulings of the treas-

¹ Ninth State Conference on Taxation, Utica, N. Y. 1920, page 129 of "Proceedings".

ury department lay emphasis on methods of business having been adopted "deliberately to save taxes", as though this in itself is a wrongful thing to do and judges sometimes refer to tax saving in the same tone. But when the issue has been squarely presented, our courts have been clear and emphatic in distinguishing between tax "avoidance" and tax "evasion," upholding the one and condemning the other. A moment's consideration will show that this must be so. Otherwise there could be no certain line between a taxable and non-taxable basis. Moral considerations seem to me to lead to the same conclusion. The ethical principles of taxation are said to involve uniformity and universality. Professor Seligman² concludes that the modern idea of equality of taxation means "an equality in the sacrifice imposed upon an individual" and a consideration of his ability to pay, and says: "the easier it is for a man to make his money, the more ability he has to pay taxes; the harder it is for a man to be deprived of his money, the less ability he has to pay taxes." Universality means "that everyone should be taxed and that no one, in contra-distinction to his neighbor should be taxed more than once." The means, however, by which taxes are to be made equal with respect to ability to pay and are to be imposed upon all, lies entirely within the power of the legislators. The laws the legislators pass represent their opinions of equality and universality. These opinions may or may not correspond with true conditions. For example legislators have decided that corporations enjoy "privileges" which make it comparatively "easy" for them to pay taxes, and accordingly tax them in manners and at higher rates than they tax individuals in business. If business men generally quit the corporate form and revert to partnerships or adopt the business "trust estate" as a means of organization, they would prove that the discrimination in taxation against corporations is based upon an erroneous idea of corporate advantages. In 1902 Richard W. Hale said:³ "Where private enterprise is seriously taxed on the false ground that the State confers a greater favor by allowing two or more to do an otherwise indifferent and permitted thing, there the Massachu-

² Article on Taxation in Vol. 26 THE AMERICAN ENCYCLOPEDIA, pp. 287-294.

³ Letter to the Chronicle, dated at Boston, Aug. 12, 1902.

setts development of a trust will spread and grow. The limited liability of its stockholders has been sustained by the Federal Courts, to the rest of its machinery only applies the simplest principles of trusts under wills such as any layman is familiar with and the skill of the draughtsman will supply all that can be desired to the largest enterprise. It is to be hoped that a proper appreciation will be shown of what corporations, because of this situation, *do not need from the Legislature*".

Exemption of income from municipal and state securities from federal income tax violates the ethical principle of universality. But the more people there are who take advantage of this condition and acquire exempt securities the more nearly is universality approached. If but few carefully advised persons take advantage of so-called "loop-holes" in the law, the many who do not are actually discriminated against. In other words, free adoption of tax saving methods tends to make *fair* what legislators have made *unfair* and they make manifest errors in tax legislation which should be corrected. Therefore, I say that tax avoidance is right morally; that it is right for the tax payer to "get away with whatever he can", barring misrepresentation and concealment.

Let us now see what our courts have to say about "avoidance" and "evasion". The first important case is the decision of the United States Supreme Court in *U. S. v. Isham*.⁴ An Act of June 30, 1864, imposed a stamp tax on promissory notes. Isham, the superintendent of a mine, gave in payment for expenses, for running the mine, a form of commercial paper known as memorandum checks, instead of promissory notes. The memorandum checks were not immediately payable and had the same result as if promissory notes had been given. No stamps were attached to them. The Government contended that the giving of these post-dated checks constituted evasion of the Act and that the amount of the stamp tax should, nevertheless, be imposed. The United States Supreme Court, however pointed out that memorandum checks were well known in commercial law and if the result of using this form of paper was the saving of the tax, the taxpayer merely exercised a legal right. The Court said that "if a device to avoid taxation is carried out by means of legal forms,

⁴ (1873), 84 U. S. (17 Wall.) 496, 21 L. Ed. 728.

it is subject to no legal censure." An example of saving taxes under an earlier stamp tax act of 1862 was given to illustrate the point. This earlier act imposed a duty of two cents upon a bank check when drawn for an amount of not less than \$20. The Court said: "A careful individual, having the amount of \$20 to pay, pays the same by handing to his creditor, two checks of \$10 each. He thus draws in payment of his debt, two checks to the amount of \$20 and yet pays no stamp duty. This practice and this system he pursues habitually and persistently. While his operations deprive the Government of the duties it might reasonably expect to receive, it is not perceived that the practice is open to the charge of fraud. He resorts to devices to avoid the payment of duties, but they are not illegal. He has the legal right to split up his evidence of payment and thus avoid tax."

Construing a case of the conveyance of property in trust and the possible avoidance thereby of inheritance taxes, Mr. Justice Holmes, recently said: "*We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other and if, on the safe side it is legal if a party has availed himself to the full of what the law permits. When an act is condemned as evasion what is meant is that it is on the wrong side of the law as indicated by the policy, if not by the mere letter of the law.*"

The changing of residence by an individual in order to avoid taxation has long been recognized as the exercise of a lawful right.⁵ The Supreme Judicial Court of Massachusetts said:

⁵ Cooley, *TAXATION*, 3rd. ed., p. 767.

"It is well settled that a man may change his habitancy or domicile from one town to another, merely because he wishes to diminish the amount of his taxes. If he really intends to change his residence, and does change it, the motive which prompts him to do so is not material."⁶ In commenting on this, Frederick N. Judson,⁷ says: "The same principle obviously applies as that announced by the Supreme Court in cases where it was claimed that a man had changed his residence for the purpose of affecting the jurisdiction of the Federal Court. The sole question is whether the change was made in good faith, that is, was actu-

⁶ *Draper v. Hatfield* (1878), 124 Mass. 53.

⁷ *POWER OF TAXATION*, p. 478.

ally made." What good faith means is further illustrated by a definition quoted in Words & Phrases: "The phrase 'in good faith' as it is used in the law simply means honestly; without fraud, collusion or deceit; really, actually, without pretense."⁸

The most recent case to discuss the differences between tax avoidance and tax evasion is *Weeks v. Sibley*.⁹ In this case the United States District Court for the Northern District of Texas holds that the transfer of a business to a trustee in order to avoid corporate taxation does not constitute an evasion. It appears that there was organized in 1918, an unincorporated joint stock company, or association, known as the Thrift Oil and Gas Company No. 4, for the purpose of developing an oil gas lease in Wichita County, Texas. The operations of the company were successful and the property became very valuable. On August 19, 1919, the company was, by vote of its shareholders, dissolved and its assets conveyed to a trustee under a trust agreement which gave him absolute control of the property. On September 3, 1919, the trustees sold the trust property for \$475,000. cash and \$593,750. to be paid from a certain percentage of the oil to be produced from the property. The trust agreement provided for the periodical distribution of the income from the trust. The question of how the transaction was to be handled for income tax purposes, was submitted to the Bureau of Internal Revenue, December 1919, but no ruling was made until May 29, 1920. In due course, the trustee made a fiduciary income tax return, showing the names and addresses of the beneficiaries and the amount which they had received from the transaction. Thereafter, the Bureau of Internal Revenue ruled that the dissolution of the joint stock association and the transfer of its property to the trustee was a device to escape taxation and ineffective. A beneficiary of the trust brought suit to restrain the trustee from making a return of taxes, except as a trustee, and the Court sustained his action. In its opinion, the Court points out that the Revenue Act provides for taxation of trust estates and that under the decision in *Crocker v. Malley*,¹⁰ trusts

⁸ *Doctor v. French*, 91 Wis. 468, 65 N. W. 161.

⁹ 269 Fed. 155. See also "TRUST ESTATES AS BUSINESS COMPANIES" 2nd Ed.

¹⁰ 249 U. S. 223, 39 Sup. Ct. 270, 63 L. Ed. 573, 2 A. L. R. 1601.

having many of the features of a corporation were, nevertheless, true trust estates and taxable as such, and says:

"It therefore appears that, if the purpose and the motive which prompted the dissolution of Thrift Oil & Gas Company No. 4 is not illegal, nor a fraud upon the revenue, the complainant's contention in this respect is correct, and no income accrued to Thrift Oil & Gas Company No. 4 by virtue of the transaction.

"It is insisted in the opinion of the solicitor for the Bureau of Internal Revenue that this change is a sham and a subterfuge and is ineffective. This same opinion admits the right of an individual or corporation to regulate or change its business, with a view of reducing or avoiding taxation in the future, but in contradiction with this admission holds that the parties involved in this transaction could not do so. Supporting this view there are several cited cases, most of them by state courts. The case of *Pollard v. Bank*, 47 Kan. 406, 28 Pac. 202, cited by the solicitor, is directly opposed to his contention. The basis of the decision in the case of *Ransom v. City of Burlington*, 111 Iowa, 77, 82 N. W. 427, is not that an owner of property may not transfer his property or any part thereof for the purpose of avoiding any sort of tax, but the case holds that the purported transfer in the case of a strip from the front of a city lot, made for the purpose of avoiding a paving assessment, did not in fact pass title, and for that reason the property was subject to taxation in the hands of the purported transferor. The same case held:

'While one may lawfully dispose of his property to escape taxation, even taxation of a general character, the law will not uphold any mere manipulation under the guise of disposition, the only effect of which is to defeat a tax.'

"Other cases are cited involving the purchase of tax-exempt government securities at the beginning of a taxable year and the conversion of a cash deposit in a bank into greenbacks at a similar time, the holding of such tax-exempt property for a few days, and the immediate reconversion of same into taxable property for the purpose of escaping the burden of state taxation; the theory of those carrying on these manipulations being that, when they could strictly say that on the day tax liability was fixed they had no such taxable property, they could then immediately reconvert into property subject to taxation, and thus enjoy the benefits of the property subject to tax, and escape the burden of the tax.

"These cases are easily distinguished from the case at bar. There is nothing in the record in this case remotely indicating that the dissolution of the Thrift Oil & Gas Company No. 4 was not permanent, and that the shareholders by said dissolution did not permanently and finally abandon and relinquish all of the benefits which might thereafter have arisen on account of their organization as an association. To bring the character of cases above cited in line with the instant case, it would have to be held in the bond and currency cases that, if the individual making the change had continued to hold the tax-exempt property, he would nevertheless, on account of his intention of escaping taxation, be liable therefor, and thus we would have the strange spectacle of constitutional provision overridden, because a citizen intended to avail himself of all of the advantages guaranteed to him by the Constitution.

"Bearing in mind the rule of construction which the Supreme Court announced in the case of *Gould v. Gould*, 245 U. S. 151, 38 Sup. Ct. 53, 62 L. Ed. 211, and numerous other cases, to the effect that the provisions of the taxing statutes are not to be extended by implication beyond the clear import of the language used, and that they are to be construed most strongly against the government and in favor of the taxpayer, *it is the opinion of this court that the right to change the status of an organization, or to dissolve an organization in any legal manner, is not made ineffectual because the motive impelling the change is to reduce or avoid taxation in the future. The right so to do is an incidental right, inseparably connected with an individual's right to own and control his property. It is practically identical with the sale by a citizen of tax-burdened securities and the investment of the proceeds thereof in tax-exempt ones, for the purpose of reducing or avoiding taxation. It is not unnatural that any thoughtful business man take such steps. It is altogether different from tax dodging, the hiding of taxable property, or the doing of some unlawful or illegal thing in order to avoid taxation.*"¹¹

Summarizing from the foregoing it is clear that:

- (1) Tax "avoidance" is distinguishable from tax "evasion".
- (2) Courts recognize that it is "not unnatural that any thoughtful business man take such steps" as shall result in exemption from or saving from taxation.

¹¹ Italics supplied.

- (3) For such steps to be "effective" and legally innocent they must be taken in "good faith".
- (4) Good faith in this connection means that they must be taken openly and actually.

To translate these principles into practice, means that the tax payer must (1) Keep reliably informed of the various methods of transacting business and their relative taxability. (2) He must act with sufficient promptness to avoid accusation that any change he makes is not "actual" and in order that such advantage as is obtained may last as long as possible before the next legislative change in subjects or persons taxed. (3) He must show his "good faith" by acting openly and without pretense, and for the same reason, the transaction must be "actual" in every respect as distinguished from a pretended or a mere book-keeping transaction.

So diverse are tax laws, so confusing and prejudiced in favor of the Government are the rulings and decisions of tax collecting officials, so frequent are the legislative changes, that nobody but a specialist can be expected to know what methods are presently available for tax saving, and against his recommendations there must always be weighed the effects of the change upon other phases of the business. In the larger organizations the matter of taxes is placed in charge of special tax departments under or closely related to the legal departments. To these organizations, therefore, there is always available the legal slant on every contemplated tax saving. This is of the utmost importance, since nearly every method of tax avoidance presents distinctions requiring close application of legal principles and decisions. The doing of business as individuals through a trusteeship or partnership may or may not entail legal consequences not contemplated by the inexperienced. On the other hand large savings may be thus accomplished by particular enterprises, without loss of a single real advantage. Corporations may lawfully and effectually reduce state franchise taxes by using a subsidiary for trading in foreign states. Careful counsel will see, if this plan is adopted, that the subsidiary corporation actually carries on the business as an independent entity, and not as a "mere book-keeping" transaction. If it is feasible to conduct business

in such manner as to constitute interstate commerce and thereby escape state taxation altogether, difficult legal problems of just what constitutes interstate commerce as applied to the particular business in hand, and what constitutes "doing business" in a state so as to constitute "intrastate" commerce subject to state and local taxation, must be weighed and decided. Saving or reduction of inheritance taxes by the creation of voluntary trusts or by the organization of holding corporations involves knowledge of the laws of many states and their construction by the courts. These are mere instances of situations to which counsel can bring a point of view of benefit to tax payers. But because of the fact that the ordinary business man and the smaller corporation does not employ counsel as regular adjuncts to their businesses, *they are deprived of the advice in the advance of action so necessary to tax saving or effective tax avoidance.* The situation is not unlike that of our health. Going to doctors after we are sick is not nearly so conducive to a long life as consultation in advance and while we are in good health. Just as the Life Extension Institute has met this situation by regular examinations and recommendations, attorneys skilled in tax matters should be consulted from time to time with respect to taxation. This should be done in advance of the time for tax returns and before a business or reorganization has been embarked in a particular form or in a particular taxing district. A tax survey or analysis of a given situation is today an incident of a carefully conducted business just as necessary as insurance. Those who do not take these precautions are certain to be burdened with a larger proportionate share of the public expense than are those who take both time and taxes by the forelock.

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